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Nos. 184, 185, 186

In the Supreme Court of the United States

OCTOBER TERM, 1935

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN J. WATTS

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HUGH C. SICARD

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PARKER SLOANE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The majority, concurring, and dissenting opinions in the United States Board of Tax Appeals

(R. 28–38) are reported in 28 B. T. A. 1056. The opinion of the Circuit Court of Appeals (R. 91–95) is reported in 75 F. (2d) 981.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on March 11, 1935 (R. 95–96). A petition for rehearing was denied on March 27, 1935 (R. 98). The petition for a writ of certiorari was filed June 27, 1935, and granted October 14, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Pursuant to an agreement executed in 1924 with Vanadium Corporation, the three taxpayers, owning all the stock of Alloys Corporation, exchanged their stock for Vanadium stock and short-term bonds to be secured by the assets of Alloys, and to be guaranteed by Vanadium as to principal and interest, with the privilege of paying the principal on 90 days' notice. The Vanadium stock which the taxpayers received in exchange for their Alloys stock was to be held in escrow during the year 1925, and the exact amount to be delivered to the taxpayers would depend on the earning power of Alloys demonstrated during 1925. Alloys was dissolved in 1928. The questions presented are:

1. Whether the taxpayers are relieved from taxation on the gain realized from the transaction by

the exceptions to Section 203 (a) of the Revenue Act of 1924. This depends upon whether the definition of the term "reorganization" contained in Section 203 (h) (1) (A) of the Revenue Act of 1924 should be limited to transactions which partake of the nature of mergers or consolidations.

2. Assuming that the transaction was a reorganization within the meaning of Section 203 (h) (1) (A) of the Revenue Act of 1924, whether the gain realized from the transaction by the taxpayers should be recognized to the extent of the principal amount of the Alloys bonds, namely $1,161,184.50, under Section 203 (d) (1) of the Revenue Act of 1924. This depends upon whether the bonds are "securities" within the meaning of Section 203 (d) (1) of the Revenue Act of 1924.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 24–28.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 29–38), may be summarized as follows:

The three taxpayers owned all of the stock of United States Ferro Alloys Corporation, hereafter called "Alloys", consisting of 30,000 shares with a par value of $100 each. On or about December 6, 1924, one of the taxpayers, acting in behalf of the others as well as himself, entered into a written agreement with the Vanadium Corporation of

America, hereafter referred to as "Vanadium" (R. 29–30).

According to the agreement, the taxpayers agreed to exchange all of their Alloys stock for 66,666⅔ shares of Vanadium, together with bonds aggregating $1,161,184.50, secured by a trust mortgage on the Alloys plant at Niagara Falls, New York, and guaranteed as to payment of principal and interest by Vanadium. The mortgage agreement was to provide that Vanadium should always have on hand for the use of the Niagara Falls Plant at least sixty days' supply of such materials and products as might be necessary to employ the power then under contract, and there was to be a clause providing for the privilege of payment of the principal at any time on 90 days' notice (R. 31). The agreement also provided that Vanadium, upon receipt of the Alloys stock, would immediately pay $338,815.50 to certain creditors of Alloys, would satisfy certain other liabilities of Alloys from future earnings of Alloys, and that the taxpayers would assume all other liabilities, for which they agreed to post a bond (R. 32, 57).

It was agreed that the contract should be carried out on December 19, 1924, at which time all of the stock of Alloys duly endorsed, together with resignations of the officers and directors of Alloys, should be delivered to Vanadium, and that Vanadium should thereupon place 66,666⅔ shares of its stock in escrow with a trust company, and should

deliver to Alloys the bonds described above and immediately pay the amounts it had assumed to pay under the contract. The agreement also provided for a complete audit of the business, properties, and profits of Alloys, and the parties agreed that the escrow deposit of Vanadium stock should be dissolved on January 1, 1926, and that the exact number of shares of Vanadium to be then delivered to the taxpayers should be determined on the basis of the earning power of Alloys demonstrated during 1925 (R. 32). By a supplemental agreement dated December 18, 1924, the amount of stock which Vanadium was to exchange with the taxpayers was reduced to 33,333⅓ shares. The stock of Vanadium was of no par value, and for the purposes of the agreement its value was fixed at $30 per share (R. 32).

The contract was duly executed in accordance with its terms, but as a result of the demonstrated earning power of Alloys during the year 1925 only 32,103 shares of Vanadium were delivered to the taxpayers. Concurrently with the closing of the transaction, Vanadium paid to the creditors of Alloys the sum of $338,815.50 (R. 33). In July 1928 a certificate of the dissolution of Alloys was filed in the office of the Secretary of the State of New York (R. 33).

In the respective deficiency letters to the three taxpayers, the Commissioner held in substance that the transaction involved was a sale of the 30,000

shares of Alloys for the sum of $2,500,000, and determined that each of the taxpayers derived a capital net gain of $507,534.65 (R. 33). The taxpayers appealed to the Board of Tax Appeals on the ground that the transaction was a tax-free reorganization under Section 203 of the Revenue Act of 1924 (*infra*, p. 24), and that no gains should be recognized. The Board of Tax Appeals decided, with five members dissenting, in favor of the Commissioner and determined a deficiency of more than $63,000 in the case of each taxpayer for the year 1924 (R. 38, 39).

The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals and held that the transaction was a reorganization under the statute and the applicable Treasury Regulations (R. 91–95). The Commissioner of Internal Revenue filed a petition for rehearing on the ground that the decision of the court in the instant case, in failing to hold that the taxpayers had realized a gain at least to the extent of the value of the bonds received by them in the transaction, was inconsistent with a decision of the same court in *Worcester Salt Co.* v. *Commissioner*, 75 F. (2d) 251, in which it was held that bonds are merely an evidence of indebtedness and are not "securities" within the meaning of the reorganization provision of the Revenue Act (R. 96–97). The Circuit Court of Appeals denied the petition for rehearing on March 27, 1935 (R. 98).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In failing to hold that the definition of the term "reorganization" contained in Section 203 (h) (1) (A) of the Revenue Act of 1924 should be limited to transactions which partake of the nature of mergers or consolidations.

2. In giving effect to an administrative construction which is inconsistent with the statute.

3. In denying the petition for rehearing and failing to give effect to its own decision in another case that bonds are not "securities" within the meaning of Section 203 (d) (1) of the Revenue Act of 1924.

4. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

1. The definition of "reorganization" upon which respondents rely is contained in the same parenthetical clause discussed in the brief for petitioner in *Guy T. Helvering, Commissioner of Internal Revenue* v. *Minnesota Tea Company,* No. 174, present term. For the reasons there stated we contend that the definition should be limited to mergers and consolidations or transactions which partake of their nature.

2. The transaction here involved fails to substantially conform to certain basic elements found in mergers and consolidations. Respondents' position was substantially changed as the result of the exchange of their Alloys stock for Alloys bonds

and Vanadium stock. Inasmuch as the bonds do not represent a proprietary interest, respondents *pro tanto* disposed of their proprietorship. There was no plan of reorganization and the only plan shown was between an individual and a corporation. Vanadium merely made an investment in Alloys and had only the rights of a stockholder after the transaction. The two corporations continued their separate activities and the Vanadium Corporation did not assume all the liabilities of Alloys. We submit that the transaction did not partake of the nature of a merger or consolidation.

3. It is settled that the transferor in a reorganization must retain an intimate interest in the business conducted by the transferee. Since the statute provides for the receipt, tax free, only of stock or securities, it appears that the required continuity of interest should be evidenced by the required stock or securities. An exchange of stock for bonds results in a substantial change of position and we think that bonds represent "other property" which is required to be taxed, rather than "securities" which are tax free. Moreover, the bonds in these cases were callable on 90 days' notice, 10% became due within six weeks, and portions of the remainder matured annually over a seven-year period. We think that such bonds represent a method of eliminating the interest of respondents rather than of continuing it.

ARGUMENT

I

THE CLAUSE (A) DEFINITION OF "REORGANIZATION" SHOULD BE RESTRICTED TO TRANSACTIONS WHICH RESULT IN MERGERS OR CONSOLIDATIONS OR PARTAKE OF THEIR NATURE

The general rule of the statute is that the gains upon exchanges are taxable. To this there are certain specifically defined exceptions. Respondents contend that the transaction here involved is literally within the language of one of the exceptions (Section 203 (b) (2), Revenue Act of 1924, *infra*, p. 24), which provides in substance that the gain will not be recognized if stock in a corporation which is a party to a reorganization is exchanged for stock in another corporation which is also a party to the reorganization. Accordingly, the cases turn upon whether the transaction involved was a reorganization within the meaning of the statute. The portion of the definition of reorganization upon which respondents rely is as follows (Section 203 (h) (1)):

> The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation * * *.

The Government contends that the parenthetical language upon which respondents rely is colored and controlled by the words "merger or consolidation" and that to be within the definition a transaction must partake of the nature of a merger or consolidation though it fails to satisfy all of its legal requirements. This contention is fully developed in the brief for petitioner in *Guy T. Helvering, Commissioner of Internal Revenue* v. *Minnesota Tea Company,* No. 174, present term, and Point I of the argument in that case is therefore incorporated herein by reference.

While the transaction in these cases was not a transfer of corporate assets, and there is no overlapping definition in clause (B) dealing directly with a majority stock control of one corporation by another, nevertheless, the portion of the clause (A) definition upon which respondents must rely is a part of the same parenthetical clause discussed in the *Minnesota Tea Company* brief. Therefore, we think that if one portion of the parenthetical clause refers to a transaction resembling a merger or consolidation, it logically follows that another portion of the same parenthetical clause likewise refers to a transaction having a similar resemblance. Therefore, we submit that the argument advanced in Point I of the *Minnesota Tea Company* brief is equally applicable here.

II

THE TRANSACTION BETWEEN THE VANADIUM CORPORATION AND AN INDIVIDUAL STOCKHOLDER OF THE ALLOYS CORPORATION DID NOT SUFFICIENTLY PARTAKE OF THE NATURE OF A MERGER OR CONSOLIDATION TO BE TREATED AS A REORGANIZATION

By the transaction here under scrutiny the three stockholders of the Alloys Corporation delivered all of that company's stock to the Vanadium Corporation, receiving in exchange, or as consideration, certain bonds of the Alloys Corporation and certain stock of the Vanadium Corporation. In addition, the Vanadium Corporation agreed to pay certain specified liabilities of the Alloys Corporation and respondents assumed the liability of Alloys for 1924 taxes, which latter item was allowed by petitioner as additional cost of the Alloys stock to respondents (R. 33).

We think that the transaction fails in several particulars to satisfy the statutory requirements: (1) there was no plan of reorganization; (2) the transaction was not one between two or more corporations; (3) both the Vanadium Corporation and the Alloys Corporation remained in existence after the transaction; (4) the proportion of stock to other property received as consideration or in exchange was so small that respondents' proprietary interests were substantially changed; (5) the Vanadium Corporation did not assume all of the liabilities of Alloys.

We shall briefly discuss each of the points enumerated above:

(1) The record shows that the transaction occurred as the result of an agreement between the respondent Sloane, acting individually and as trustee, as party of the first part, and Vanadium Corporation as party of the second part (R. 55), whereby the Vanadium Corporation was to acquire all of the capital stock of Alloys Corporation. The Alloys Corporation acquired nothing as a result of the transfer. Neither did it give up anything. The Alloys Corporation was simply the subject matter of the agreement. The Vanadium Corporation acquired a wholly owned subsidiary which it did not absorb and which remained wholly independent as a separate corporation. The agreement did not contemplate that the Vanadium Corporation should succeed as a corporation to the estate, property, rights, privileges, and franchises of Alloys, but merely that Vanadium should own the stock of Alloys. Unless a literal application of the statutory language is consonant with its purpose, we submit that the plan was not a plan of reorganization.

(2) The transaction was consummated by respondent Sloane and the Vanadium Corporation. It was not a transaction between two corporations. Under Section 203 (b) (2) of the Revenue Act of 1924, upon which respondents rely, the Alloys Corporation should have been a party to the reorganization, and since it did not participate in the trans-

action, we submit that respondents' claim should fail. It is true that section 203 (h) (2) provides that the term "a party to a reorganization" includes both corporations in the case of an acquisition by one corporation of at least a majority of the stock of another corporation, but this does not necessarily indicate that a corporation may be "a party to a reorganization" without even participating in it. It seems incredible that the statute was intended to apply to a situation where one corporation acquires a majority of another corporation's stock through independent arrangements with the individual stockholders of the acquired corporation, and we therefore submit that the statute contemplates that both corporations shall be participants in the transaction. Respondent Sloane was acting for himself and as trustee for the other respondents. But under the agreement it was expressly understood that Vanadium had no obligation to recognize anyone other than respondent Sloane and had no duty with respect to the application of the consideration by respondent Sloane (R. 64). Therefore, it appears that the Vanadium Corporation and Sloane individually were the only active participants in the transaction, and, while Sloane undertook to deliver all of the Alloys stock, Vanadium did not propose to deal with anyone but him. The agreement seems to limit the parties to Sloane and Vanadium.

(3) After the transaction, Alloys and Vanadium existed at the same time, pursuing their separate activities. Vanadium undertook to keep available for the use of Alloys at least a 60 days' supply of such material and products as might be necessary to employ the power for which Alloys had already contracted (R. 59). Vanadium undertook to pay two specific creditors of Alloys, and after the payments were made Vanadium appeared on the books of Alloys as a creditor to the extent of $338,000 (R. 33). Part of the consideration paid to respondents for the Alloys stock transferred to Vanadium consisted of certain bonds of Alloys of which a definite portion of the principal amount became due annually from February 1, 1925, to January 1, 1932, inclusive (R. 59). At the time of the transaction it was thus obviously intended that both corporations should continue to exist, and it was not a part of the plan that Alloys should be dissolved after winding up its affairs. Although Alloys was dissolved in 1928 (R. 33), this was not a part of the plan in 1924, and has no effect upon the question here presented. The statute does not deal with a mere association of coexisting corporations, but with a continuing business in a new form. For the reasons more fully explained in the *Minnesota Tea Company* brief, we submit that the transaction here involved fails to meet this important requirement.

(4) The net consideration for the transfer of Alloys' stock to Vanadium was $2,080,911.42. Of this amount $1,161,184.50 consisted of bonds. In addition, payments were made by Vanadium to two creditors of Alloys in the total amount of $338,-815.50 (R. 33). Furthermore, the agreement contained a provision whereby $500,000 in cash would have been paid by Vanadium if the 1925 earnings of Alloys had justified it (R. 66). Since the only part of the consideration which represented property of a similar character to that transferred by the respondents was the $963,090 in Vanadium stock,[1] it can be seen that the proportion of the consideration which consisted of stock was less than 50%. Accordingly, by this transaction respondents transferred a 100% proprietary interest in the Alloys Corporation, but did not receive a proprietary interest in the Vanadium Corporation substantially equivalent to the value of the Alloys stock. We submit that this does not represent a mere change in the form of the respondents' investment, *but that they had, in effect,* permanently disposed of a large proportion of their proprietary interest and had, *pro tanto,* radically changed their position. In the *Minnesota Tea Company* brief we have contended that a corporation which transfers its assets in connection with a transaction which is

[1] $1,000,000 less $36,910, the value of the undelivered stock (R. 33).

recognized by the statute as a reorganization must preserve its proprietary interest in the assets transferred by retaining a continuity of interest which is the substantial equivalent of the property transferred. We think that the same principle is applicable to transactions under the portion of the clause (A) definition which is here involved, and for the reasons given in the *Minnesota Tea* brief we submit that the respondents did not preserve a sufficient proportion of proprietary interest to satisfy the statute. If the continuity of interest which is required of a corporation as a result of the decision in *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462, it to be subject to close scrutiny in determining whether a formal or a substantial change has occurred, we submit that the failure of the Alloys Corporation to participate in the transfer in these cases does not eliminate that necessity.

(5) As pointed out in the *Minnesota Tea Company* brief, it is one of the indicia of a merger or consolidation as distinguished from a sale that the surviving corporation undertake to assume the liabilities of the predecessor corporations. With the exception of specific items of $255,000 and $338,815.50, it appears that respondents, and not the Vanadium Corporation, assumed the liabilities of the Alloys Corporation (R. 57, 62–63).

For the above reasons, we submit that the transaction in question was not a reorganization.

The Circuit Court of Appeals fell into the error of applying the statute literally. It said (R. 92):

> The controlling facts may be stated in one sentence. The petitioners [respondents] exchanged all of the stock of Alloys solely for stock in Vanadium and bonds of Alloys.

These are not the only controlling facts, we submit, if there is to be an adherence to the broad principles which actuated Congress in enacting the reorganization provisions. The intention of Congress to relieve from the tax those transactions which resulted only in a change of form led to the proposal to postpone the tax in cases of mergers or consolidations. The other provisions of the clause (A) definition were not written with any different purpose, but merely to extend the statute to similar transactions. The statute deals in clause (A) with mergers or consolidations; in clause (B) with transfers of assets to a controlled subsidiary; in clause (C) with recapitalizations; and in clause (D) with mere changes in identity, form, or place of organization. Unless the parenthetical language of clause (A) be an exception, the entire definition of reorganizations deals with transactions which involve mere formal changes. This Court has held that the definition may not be applied literally, but that where one corporation transfers its assets it must retain its interest therein. We think that the structure of the statute reflects the purpose to re-

strict its benefits and that it is implicit that substantial changes are beyond its purview. The experience of the Treasury shows that the statute is open to abuse if its provisions are applied with precision to sales which take the technical form of reorganizations.

The decision of the Circuit Court of Appeals, insofar as it relies upon the administrative practice and accepts literally Example (3) in Article 1574 of Regulations 65 (*infra*, p. 26), covering "sales", is at variance with its prior holding in *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937. The Circuit Court of Appeals failed to note that the regulations emphasize that the statute is dealing with corporate reorganizations "which result only in a change in form and which do not substantially affect the property interests either of the shareholders or of the corporations," and it failed to heed the cautionary statement that "the statute does not allow the use of reorganizations to avoid tax."

The Circuit Court of Appeals was in error in stating that the definition of reorganization was reenacted without change in the Revenue Act of 1924 (R. 94), and it failed to appreciate that a literal construction of the statute could not be supported after the Revenue Act of 1924 introduced the definition in clause (B). At this point we desire to incorporate the discussion in the *Minnesota Tea* brief (pp. 29–31) with respect to the administrative prac-

tice, as well as the matter in Appendix B to that brief.

We submit that the Circuit Court of Appeals erred in failing to give consideration to the question whether the transaction partook of the nature of a merger or consolidation. We submit further that measured by such a test the transaction here involved fails to satisfy the statute.

III

THE GAIN UPON THE TRANSACTION WAS TAXABLE, AT LEAST TO THE EXTENT OF THE PRINCIPAL AMOUNT OF THE BONDS

If the construction of the statute for which we contend be adopted, and it be held that the transaction here involved did not partake of the nature of a merger or consolidation, it will be unnecessary to consider this question. But, assuming that the transaction is within the statute, we contend that the decisions of the court below should be reversed upon the independent ground that the Alloys Corporation bonds were not "stock or securities" within the meaning of Section 203 (b) (2), Revenue Act of 1924 (*infra*, p. 24).

The only kind of property which is relieved from taxation is stock or securities. If the consideration for the transfer consists of "other property or money", Section 203 (d) requires that the gain be recognized and taxed to that extent. This Court has held in *Pinellas Ice Co.* v. *Commissioner*, 287 U. S.

462,470, that the transferor must retain a continuing interest in the affairs of the "purchasing company more definite than that incident to ownership of its short-term purchase-money notes." Since stock or securities are the classes of property specifically exempted, it is logical to assume that the required continuity of interest should be represented by such property exclusively. Clearly the Alloys bonds are not stock, and we think they do not constitute "securities" within the meaning of the statute.

We appreciate that corporate bonds are commonly regarded as securities under statutes designed for different purposes. But the question here is whether Congress intended to ignore for tax purposes an exchange of stock in the Alloys Corporation for bonds of the Alloys Corporation. Such a transaction is ordinarily treated as resulting in a substantial change of position and it is significant that Section 203 (b) (1), dealing with tax-free exchanges not accomplished through reorganizations requires that common stock be exchanged for common stock and that preferred stock be exchanged for preferred stock. In the present case it would seem clear that respondents have substantially changed their position from investors with funds at the risk of the business to creditors with a lien upon the assets. The notes in the *Pinellas* case, *supra,* were secured by a first lien on the property conveyed, but this Court held

such notes did not represent the prescribed continuity of interest. We think the same rule is applicable here. The fact that the bonds were callable at any time on 90 days' notice (R. 59) is another similarity to the short-term notes in the *Pinellas* case. The agreement between the parties was to be carried out on December 23, 1924 (R. 60), and $161,184.50 of the principal amount of the bonds became due and payable February 1, 1925 (R. 59). It is difficult to conceive of such bonds representing a continuity of interest. Moreover, definite portions of the remaining bonds became due annually until January 1, 1932, and we submit that instead of representing a continuity of interest the bonds represent the means of eliminating respondents' interests.

In *John A. Nelson Co.* v. *Commissioner,* 75 F. (2d) 696 (C. C. A. 7th), now pending on writ of certiorari, No. 61, present term, where a corporation transferred its assets in consideration for cash and preferred stock, it was held that the preferred stock, which was nonvoting, did not represent a voice in the control of the new corporation and did not preserve the required continuity of interest. If a transfer of assets for preferred stock does not preserve a continuity of interest, we submit that, *a fortiori,* an exchange of common stock for bonds does not satisfy the statute. Unlike preferred stock, bonds do not represent even a proprietary interest in the business.

Our argument does not leave the term "securities" without a meaning. It occurs in the phrase "stock or securities", and we think the statute refers to securities having similar attributes to stock. The term probably includes stock rights and stock warrants which may be converted into stock at the option of the holder.

The court below has itself held that bonds are merely an evidence of indebtedness which represent no continuity of interest. *Worcester Salt Co.* v. *Commissioner,* 75 F. (2d) 251. If bonds do not represent a continuity of interest, we submit that they cannot be deemed to be "securities." Since a transfer may be a reorganization where the consideration consists solely of stock or securities (Section 203 (b) (2)), it seems to follow that the required continuity of interest is represented by the required stock or securities.

If the bonds are not "securities" within the meaning of Section 203 (b) (2), they must constitute "other property" within the meaning of Section 203 (d), and the gain should be recognized to the extent of the value of the bonds ($1,161,194.50), which is less than the total profit (R. 33).

CONCLUSION

We submit that the decisions below should be reversed, either upon the ground that the transaction did not constitute a reorganization, or, upon

the alternative ground, that in any event the bonds are not securities within the meaning of the statute.

Respectfully submitted.

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NOVEMBER 1935.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 256:

SEC. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) (1) No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, or if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(d) (1) If an exchange would be within the provisions of paragraph (1), (2), or (4)

of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * *

(h) As used in this section and sections 201 and 204—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(i) As used in this section, the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

Treasury Regulations 65, relating to the Revenue Act of 1924:

ART. 1574. *Exchanges in connection with corporate reorganizations.*—Since corporate reorganizations which result only in a change in form and which do not substantially effect the property interests either of the shareholders or of the corporations may be required or may be made desirable by business conditions, State laws, or other causes, the statute provides that no gain or loss shall be recognized to the shareholders from the exchange of stock made in connection with the reorganization nor to the corporations from the exchange of property made in connection with the reorganization. If two or more corporations reorganize, for example, by either (1) the dissolution of corporation B and the sale of its assets to corporation A, or (2) the sale of its property by B to A, or (3) the sale of the stock of B to A, or (4) the merger of B into A, or (5) the consolidation of A and B, or (6) the acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, or (7) the transfer by A of all or a part of its assets to B where immediately after the transfer A or its shareholders are in control of B, then no taxable income is received from the transaction by corporation A or B if the sole consideration for the transfer of the assets is stock or securities of corporation A or B; and no taxable income is received from the transaction by the shareholders of either corporation A or corporation B if the sole consideration received by the shareholders is stock or securities of corporation A or B. Furthermore, if the reorganization is accomplished

by the transfer by corporation A of a portion of its assets to corporation B in exchange for the stock of corporation B and corporation A distributes as a dividend to its shareholders the stock of corporation B, no taxable income is realized by the shareholders from the receipt of such dividends. (See art. 1576.)

In conformity with the principle of ignoring for tax purposes those reorganizations which result merely in a change in form, the statute provides further that the stock received by the shareholders in connection with the reorganization shall have the same basis for the purpose of determining gain or loss from its subsequent sale as the stock surrendered by them and that the assets acquired by a corporation a party to the reorganization shall have the same basis for the purposes of depreciation, depletion, and the determination of gain or loss from subsequent sale as they had in the hands of the corporation from which they were acquired. (See arts. 1596–1598.) The exchanges made by both the shareholders and the corporations in connection with a reorganization are ignored and both are treated thereafter as if the reorganization had not occurred.

Adequate provision is made in the statute for cases in which income is actually realized by the shareholders in connection with the reorganization through the receipt of cash or property other than the stock of a corporation a party to the reorganization. (See art. 1575.) In such cases the gain to the shareholder is recognized and taxed, but in an amount not exceeding the amount of the money or the other property received in connection with the reorganization. If the money so distributed in connection with the

reorganization has the effect of the distribution of a taxable dividend, such gain is taxed not as a capital gain but as an ordinary dividend subject to the surtax rates. While placing no obstacle in the way of genuine reorganizations, the statute does not allow the use of reorganizations to avoid the tax.

Records in substantial form, showing the basis of the stock or property exchanged, and the amount of property or money received in exchange, must be kept to enable the determination of gain or loss from a subsequent disposition of the stock of property received or exchanged.

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